MORTGAGE BULLETIN

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DEAD PLEDGES

MORTGAGE is an old French legal word meaning "dead pledge." Sir Edward Coke, a great English lawyer of the seventeenth century, gave the following explanation of the meaning of mortgage: "It seemeth that the cause why it is called mortgage is, for that it is doubtful whether the feoffor will pay at the day limited such summe or not, and if he doth not pay, then the land which is put in pledge upon condition for the money is taken from him forever, and so dead upon condition, etc. And if he doth pay the money, then the pledge is dead as to the tenant, etc."

That many mortgagors will pay as agreed is probably as doubtful today as it was when Sir Edward gave his explanation of mortgage.

In the light of mortgage competition this is the time when challenges against complacency should be sounded, and so during the past months I have asked many institutional lenders whether they thought there would be a substantial amount of foreclosures within the next five to ten years. As I expected, most of them were positive that their loans were being conservatively made and that future foreclosures would be relatively few. Some, however, were not quite so confident. What is supporting this strong feeling of security among so many lenders is, in my opinion, their conviction that the present postwar pattern is not being cast in the same mold as the postwar pattern of World War I, and I find some business men who believe that real estate is on a price level which, with minor fluctuations, will endure for a decade - perhaps longer.

It is easy to recall that the same feeling of confidence and security existed in the twenties. At that time we were told that depression and panics could not happen again due to the Federal Reserve Bank System with its control over money and credits. We were led to believe that we were in a new and better phase of our economy and firmly ensconced on a higher level of prosperity where the doom dust of depression could never reach us. We are hearing some of the same cocksure talk now, but with "government controls" taking the place of the Federal Reserve Bank System as the staunch support which will make another collapse impossible. With our present full dinner pail, this argument seems plausible and convincing.

It is not strange that confidence runs high, especially among younger business men. The horizon looks bright and rosy with business moving at a highly accelerated pace, employment at an all-time high, housing in short supply, real estate selling at near top prices, delinquencies in mortgage payments few, foreclosures at an unprecedented low, and the various mortgage insurance funds growing to substantial proportions. With all of this fear-dispelling activity, the hazards involved in the present

position of the real estate cycle appear to be commanding little, if any, consideration ... but bear in mind that the 100 per cent loan would have been entirely safe in the pre-boom years of 1918, while many a 50 per cent loan made in the late 1920's has since been foreclosed.

The greatest threat, however, to sound lending is the muddy appraising that is being done. I have mentioned this in previous bulletins, but I wish to emphasize it again. The contempt of some small-minded bankers, their intolerant disdain, their super-eminent knowledge and air of complacency have been so crushing (in some instances) that it has become a venture of real boldness to enter into a discussion with them on the need of modern realistic appraising. They insist that members of their loan committee know values and all of this foofooraw about scientific appraising doesn't interest them. That a mortgagee is guessing every time he makes a loan, they will concede, but they take the position that their guess is as good as anyone's, and that charts and analyses of trends would not alter their convictions. Even in some of the larger institutions, the senior officers insist on doing some of the appraising and are constantly interfering with the mortgage officer. Bank officials should decide on a well-considered appraisal policy and then permit the mortgage officer to carry it out.

It often happens that when lending has been active and the institution is not immediately pressed with the need for mortgages, the senior officers suddenly become ultra-conservative concerning appraising; then, as the amortized payments and other mortgage funds again accumulate, their attitude quickly changes and they are willing to make loans on present costs. In other words, they blow hot and then blow cold -- and then blow hot again. I have heard many a broker say that the best time to negotiate a loan on favorable terms, particularly in relation to the appraisal, is when a bank is long on mortgage money. Then the pressure is on, and the appraisal is likely to be more liberal. Without a standardized, tested method of appraising, honestly administered, loans can be made too high in relation to value. Legal restrictions on the amount of the loan to appraised value may have but little meaning, as an "advocate" or careless appraisal can make a 60 per cent loan a 100 per cent loan, and has frequently done so. In many cases loans made too optimistically in relation to present worth are adjusted through foreclosure. Haphazard appraising and marginal loans are as closely related as the horns of a dilemma.

Many reasons have been given to account for the cycle of boom and bust in real estate. I think a prime reason, and one infrequently given, is that a new generation of business men largely dominate each cycle and repeat the mistakes of their predecessors. With their eyes on the present such men do not give sufficient study to the experiences of the past. For example: In nearly every city there are always a few mortgage lenders who ride rough-shod over all competition. Such lenders make long-term, high percentage loans, based on present costs and selling prices, and absorb the legal fees. Just recently I had a savings and loan executive tell me with pride that the other lenders in town were no competition for him and that he was making nearly as many loans as all the others put together. Another executive in the same industry told me he was not worried so long as he got the business and his loans did not exceed the selling price of the property. Such men are ambitious, above all else, in building a large institution, and their fiduciary responsibilities seem to rest lightly on their shoulders. It is probable that disillusionment and financial loss to their depositors may follow such a program ... after all, reckless lenders are but

eager beavers swimming toward the falls.

While there are many institutional lenders who express confidence that the very low current rate of mortgage default will not rise as much as "some quarters" expect, I have been deeply interested in the opinion of older bankers. These men are commercial bankers who were sitting in the driver's seat during the boom of the twenties and the depression of the thirties, and still head their institutions. Although making but few loans, and those they do make are very carefully screened, they are watching closely present mortgage developments. In talking with these well-experienced bankers they tell me, almost to a man, that we are headed for a real estate collapse worse than the crash of the thirties with foreclosures that will make the peak of 1933 look like a piker. In their opinion lessons of the last depression have made no impression on the majority of present-day lenders. When the bottom dropped out of the last boom, 450,000 farmers lost their land through foreclosure, factory payrolls fell 44 per cent and corporations' profits crashed from a net of more than 7 billion after taxes, to a net loss of 3.6 billion. Nonfarm foreclosures for the years 1932 and 1933 alone reached a total of 501,000 -- according to the Federal Home Loan Bank figures.

At the convention of the National Association of Mutual Savings Banks in Boston last May, T. Bertram King, Director, Loan Guarantee Service of the Veterans Administration, had this to say regarding future GI foreclosures: "There will be foreclosures. There always have been -- even under the most carefully screened and conservative lending practices. In this GI program there are positive elements present that should inevitably translate themselves into a relatively high incidence of future defaults. These loans are being made in a period of peak prices, they are largely non-equity loans, appraisal abuses are woven into their patterns, they have in many cases been made to veterans who have not yet found their permanent place in life, and they must carry along through periods of economic prosperity and adversity alike." I have quoted Mr. King because I agree with him and because some of the weaknesses he mentioned as present in GI loans, and which will bring about high foreclosures, are also present in conventional mortgages.

Recently I have been taken to task by several mortgage brokers on our statement that the majority of 608 loans would be foreclosed within 5 years. Their argument, first of all, is that 608 projects are well located, decently built, and highly desirable as rental apartments. They maintain that there would be few foreclosures as the FHA will go all out to prevent taking over a project even to the extent of reducing the amortization from 1-1/2 per cent to 1/2 of 1 per cent, as well as extending the original term of the mortgage. As a clincher for their argument these brokers point out that if a project does come to foreclosure in 5 years, the mortgagee will be better off than he would have been with his money invested in government bonds. Even after paying a 5 per cent premium and servicing charges to a broker and taking a one point loss on the balance of the loan when it is turned over to FHA, the net return to the mortgagee would be greater than from government bonds. The brokers fail, however, to mention that institutional lenders must earn more on their mortgage money than such a transaction would bring them and they also fail to mention that should the mortgagee choose to foreclose, the certificates of claim would be worthless. We have not revamped our stand on 608's -- let the other fellow finance them.

Much of the present mortgage activity is in refinancing. The reason for this is clear, but it should be equally clear that refinancing can result in the acquisition of

marginal loans if the appraisal technique is faulty and the property is financed at too high a percentage of the selling price. In this high-priced market with a scarcity premium still being paid for homes the problems of refinancing call for a broad experience in mortgage lending.

Mortgage lending is a good business when properly conducted, but it is a risky business in a period like the present. Many lenders, however, are reluctant to rationalize the probable volume of future foreclosures. They are loath to heed warnings feeling that they do not need them; they apparently overlook the large amount of unwilling ownership at high prices and the too optimistic financing of homes that will be eventually adjusted only through foreclosure.

From my observations of the mortgage situation and my many talks with mortgage lenders, I am convinced that the pressure for loans is undoubtedly jeopardizing the soundness of many mortgage portfolios. While undoubtedly the amortized loan will have some effect in reducing the foreclosure rate, I think that Dr. Wenzlick is right - that the rate of nonfarm foreclosures in the middle fifties will be quite high and may even approach the peak of February 1933. Farm foreclosures will also go high but will not approach their previous peaks due to the more conservative financing of farm loans at the present time.

At the present time the caldron of business is bubbling merrily and confidence in the future is strong. This has been a characteristic of all boom periods and has no significance in determining the foreclosure level of a few years hence.

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